

1
2 IN THE UNITED STATES DISTRICT COURT
3 FOR THE NORTHERN DISTRICT OF CALIFORNIA
4 SAN JOSE DIVISION

5 SANTA CLARA VALLEY) CV-08-5097-JF
6 HOUSING GROUP, INC., ET)
7 AL,) SAN JOSE, CALIFORNIA
8)
9 PLAINTIFF,)
10) JULY 19, 2011
11 VS.)
12)
13 UNITED STATES,) PAGES 1-35
14)
15 DEFENDANT.
16

17 TRANSCRIPT OF PROCEEDINGS
18 BEFORE THE HONORABLE JEREMY FOGEL
19 UNITED STATES DISTRICT JUDGE
20

21 A P P E A R A N C E S:

22 FOR THE PLAINTIFF: HOCHMAN SALKIN
23 BY: STEVEN TOSCHER
24 LACEY STRACHAN
25 SHARYN FISK
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BEVERLY HILLS, CA 90212

FOR THE DEFENDANT: U.S. DEPARTMENT OF JUSTICE
TAX DIVISION
BY: HENRY C. DARMSTADTER, III
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CERTIFICATE NUMBER 13185

1 SAN JOSE, CALIFORNIA

JULY 19, 2011

2 P R O C E E D I N G S

3 (WHEREUPON, COURT CONVENED AND THE
4 FOLLOWING PROCEEDINGS WERE HELD:)

5 THE COURT: SANTA CLARA VALLEY HOUSING,
6 GROUP.

7 THE COURT: GOOD AFTERNOON. PLEASE BE
8 SEATED AND COME TO ORDER.

9 THIS IS THE MATTER OF SANTA CLARA VALLEY
10 HOUSING VERSUS THE UNITED STATES.

11 MAY I HAVE COUNSEL'S APPEARANCES, PLEASE.

12 MR. DARMSTADTER, III: HENRY DARMSTADTER
13 AND JAMES WEAVER ON BEHALF OF THE GOVERNMENT,
14 YOUR HONOR.

15 MR. TOSCHER: GOOD AFTERNOON, YOUR HONOR.

16 STEVEN TOSCHER, SHARYN FISK AND LACEY
17 STRACHAN FOR PLAINTIFFS KRISTEN BOWES AND SANTA
18 CLARA VALLEY HOUSING GROUP.

19 THE COURT: THANK YOU.

20 WELL, THANK YOU FOR YOUR BRIEFS. THEY
21 WERE VERY, VERY HELPFUL.

22 I HAVE A QUESTION I WOULD LIKE TO START
23 WITH JUST TO FOCUS THINGS A LITTLE BIT.

24 THE GOVERNMENT IS SEEKING AN ADJUDICATION
25 THAT THE S CORPORATION WAS NEVER PROPERLY

1 CONSTITUTED. SO IF THAT WERE THE CASE THEN THE
2 CORPORATION SHOULD HAVE BEEN TAXED AS A C
3 CORPORATION.

4 I'M TRYING TO GET A SENSE OF THE BIG
5 PICTURE. MS. BOWES'S MOTION, WHICH IS FOR REFUND,
6 HER PIECE OF THE REFUND, RATHER HER LIABILITY, IS A
7 PIECE OF THE LIABILITY OF THE C CORPORATION IS
8 FAIRLY MINIMAL.

9 SO I JUST WANT TO GET A SENSE OF HOW THIS
10 PLAYS OUT. IF THE GOVERNMENT IS SUCCESSFUL ON ITS
11 MOTION, WHAT'S LEFT TO DO IN THE CASE AS A WHOLE?

12 MR. DARMSTADTER, III: YOUR HONOR, IF --
13 BEFORE THE COURT IS ALTERNATIVE REMEDIES. IF THE
14 COURT DETERMINES THAT SANTA CLARA WAS A C
15 CORPORATION THEN IT WOULD BE TAXED AS A C
16 CORPORATION AND THERE WOULDN'T BE A NEED IT
17 REALLOCATE THE INCOME FROM THE PENSION PLAN TO THE
18 OTHER SHAREHOLDERS.

19 THERE WAS SIMPLY THE PENALTY ASPECT OF
20 THE CASE, BUT THAT WOULD BE SUFFICIENT AS IT
21 PERTAINS TO TAXING THE INCOME.

22 IN OTHER WORDS, IT WOULD BE INSTEAD OF S
23 CORPORATION TAXATION WHICH PASSES THROUGH TO THE
24 INDIVIDUAL SHAREHOLDERS, IT WOULD BE A C
25 CORPORATION WHERE IT'S TAXED FIRST AT THE ENTITY

1 LEVEL THEN POTENTIALLY A SECOND TIME WHEN IT'S --

2 THE COURT: RIGHT. NO, I UNDERSTAND.

3 BUT I'M JUST TRYING TO UNDERSTAND HOW THE
4 ACCOUNTING PLAYS OUT.

5 THE TAXPAYERS IN THIS INSTANCE PAID WHAT
6 THEY WERE REQUIRED TO PAY AND NOW THEY ARE ASKING
7 FOR THAT MONEY BACK.

8 SO IF YOU ARE SUCCESSFUL IN CONVINCING ME
9 THAT THIS WAS NEVER AN S CORPORATION, JUST EXPLAIN
10 TO ME HOW THE DOLLARS FLOW AND WHAT REMAINS FOR THE
11 COURT.

12 MR. DARMSTADTER, III: CERTAINLY,
13 YOUR HONOR.

14 IN THAT CASE, IN ALL LIKELIHOOD MS. BOWES
15 WOULD BE ENTITLED TO A REFUND.

16 THE COURT: OF ABOUT \$8,000 OR SOMETHING?

17 MR. DARMSTADTER, III: I BELIEVE IT'S
18 MORE THAN THAT.

19 THE COURT: MORE THAN THAT, OKAY.

20 MR. DARMSTADTER, III: BUT THAT'S
21 CORRECT, YOUR HONOR.

22 WE WOULD TAX IT AS A C CORPORATION AND IT
23 WOULDN'T PASS THROUGH TO MS. BOWES AS AN S
24 CORPORATION TAX, SO SHE WOULD BE ENTITLED TO A
25 REFUND IN A CERTAIN AMOUNT THAT I BELIEVE

1 MR. TOSCHER AND I COULD AGREE TO THAT FIGURE.

2 THE COURT: BUT THEN WHAT HAPPENS TO THE
3 TAX LIABILITY? DO YOU COLLECT MONEY FROM THE --
4 AGAIN, I'M JUST TRYING TO UNDERSTAND WHAT THE FIGHT
5 IS ULTIMATELY ABOUT.

6 SO HOW DOES THE GOVERNMENT GET MADE
7 WHOLE? HOW DOES MS. BOWES GET MADE WHOLE? WHERE
8 DOES THAT LEAVE US IF THERE WAS NEVER AN S
9 CORPORATION?

10 MR. DARMSTADTER, III: IF THERE WAS NEVER
11 AN S CORPORATION, YOUR HONOR, WE WOULD TAX SANTA
12 CLARA AS A C CORPORATION. AND THAT WOULD BE,
13 BECAUSE PRESUMABLY I BELIEVE THEY FILED CLAIMS FOR
14 REFUND, THAT ALL OF THE INDIVIDUAL SHAREHOLDERS,
15 MEMBERS OF THE FAMILY, WOULD BE ENTITLED TO A
16 PARTIAL REFUND.

17 THE COURT: OKAY. BUT THEN HOW DOES
18 LIABILITY OF THE CORPORATION GET PAID?

19 MR. DARMSTADTER, III: THE LIABILITY OF
20 THE CORPORATION WOULD BE PAID THROUGH THE ASSETS OF
21 SANTA CLARA.

22 THE COURT: ALL RIGHT. SO.

23 I'M ASKING -- I THINK ULTIMATELY IT'S A
24 PRETTY SIMPLE QUESTION BUT I JUST NEED TO
25 UNDERSTAND IT BECAUSE I WANT TO UNDERSTAND THE BIG

1 PICTURE AS BETWEEN THE PARTIES.

2 SO AT THAT POINT SANTA CLARA WOULD OWE
3 MONEY TO THE GOVERNMENT THAT'S NOT YET PAID?

4 MR. DARMSTADTER, III: TO THE EXTENT THEY
5 MAY HAVE BEEN PAID, A GOOD PORTION OF THE MONEY IN
6 ORDER TO FILE THEIR REFUNDS.

7 APPARENTLY THERE ARE OTHER YEARS FOR
8 WHICH THEY HAVE NOT PAID AND THEY WOULD OWE THAT
9 MONEY.

10 THE COURT: ALL RIGHT.

11 SO THERE WOULD STILL BE AN OUTSTANDING
12 COLLECTION THAT THE GOVERNMENT WOULD SEEK AGAINST
13 SANTA CLARA BUT THE INDIVIDUAL SHAREHOLDERS, THE
14 FAMILY MEMBERS, WOULD ALL BE ENTITLED TO SOME SUM
15 OF MONEY BACK.

16 MR. DARMSTADTER, III: THAT'S CORRECT,
17 YOUR HONOR.

18 WE WOULD TAX ALL OF THE YEARS FOR THIS
19 STRATEGY AS A C CORPORATION.

20 AND TO THE EXTENT THAT THE INDIVIDUAL
21 SHAREHOLDERS PAY TAX ON THAT MONEY, THEN THEY WOULD
22 BE ENTITLED TO A REFUND.

23 THE COURT: OKAY.

24 SO THERE WOULD BE SOME RE ACCOUNTING THAT
25 WOULD HAVE TO BE DONE.

1 MR. DARMSTADTER, III: AND YOUR HONOR,
2 SORRY TO INTERRUPT, BUT PLEASE DON'T FEEL THAT THE
3 COURT NEEDS TO CALCULATE THAT AMOUNT. WE WOULD --

4 THE COURT: I DON'T.

5 I JUST WANT TO UNDERSTAND WHAT THE FIGHT
6 IS ABOUT BECAUSE THE GOVERNMENT, IF I'M
7 UNDERSTANDING THE PAPERS CORRECTLY, IS NOT SEEKING
8 SUMMARY JUDGEMENT AS TO WHETHER THIS WAS AN ABUSE
9 OF TAX SHELTER. THAT'S AN ISSUE THAT MS. BOWES HAS
10 RAISED BUT IT'S NOT AN ISSUE THE GOVERNMENT HAS
11 RAISED.

12 MR. DARMSTADTER, III: WE HAVE MOVED FOR
13 SUMMARY JUDGEMENT ON THE KIND OF TECHNICAL TAX
14 ISSUE WHICH IS THIS SECOND CLASS OF STOCK --

15 THE COURT: RIGHT.

16 MR. DARMSTADTER, III: -- ISSUE, BY
17 REASON OF THE WARRANTS.

18 THE COURT: OKAY. I WILL COME BACK TO
19 THAT. I JUST WANT TO MAKE SURE NOW THAT SANTA
20 CLARA DOESN'T HAVE ANYTHING TO ADD OR SUBTRACT OF
21 WHAT I JUST SAID ABOUT WHAT THE FIGHT IS ABOUT.

22 MR. TOSCHER: I THINK THAT'S CORRECT,
23 YOUR HONOR.

24 IF IT WAS A C CORPORATION MS. BOWES WOULD
25 BE ENTITLED TO ALL THE AMOUNTS SHE SOUGHT IN THE

1 COMPLAINT.

2 THE GOVERNMENT'S POSITIONS ARE MUTUALLY
3 EXCLUSIVE.

4 THE COURT: OKAY. ALL RIGHT.

5 SO LET'S TALK ABOUT THE, WHAT KIND OF
6 CORPORATION THIS WAS. AND THERE'S TWO PRONGS TO
7 THE ARGUMENT.

8 ONE IS THAT THERE WERE TWO CLASSES OF
9 STOCK. AND THE OTHER IS SO THAT THERE COULDN'T
10 HAVE BEEN AN S CORPORATION.

11 AND SECONDLY, THAT THE WARRANTS
12 NECESSARILY WERE GOING TO BE EXERCISED, WHICH IS
13 ANOTHER EXCEPTION AND A NARROWER ONE.

14 AND AS I UNDERSTAND SANTA CLARA'S
15 POSITION, YOU'RE ESSENTIALLY ARGUING THAT -- THAT
16 BOTH OF THOSE REQUIREMENTS HAVE TO BE MET. THERE
17 HAVE TO BE TWO CLASSES OF STOCK AND THAT THE
18 WARRANTS HAVE TO BE NECESSARILY EXERCISED, CORRECT?
19 THAT'S YOUR STATUTORY CONSTRUCTION?

20 MR. TOSCHER: THAT'S CORRECT, YOUR HONOR.

21 UNDER THE REGULATION IN ORDER FOR THE S
22 CORPORATION, SANTA CLARA, TO BE DISQUALIFIED UPON
23 THE ISSUANCE OF THE WARRANTS, TWO REQUIREMENTS.

24 ONE, YOU MUST BE SUBSTANTIALLY CERTAIN
25 THAT WARRANT WAS GOING TO BE EXERCISED. AND TWO,

1 IT MUST BE -- IT MUST HAVE BEEN ISSUED AT THE PRICE
2 SUBSTANTIALLY LOWER THAN THE VALUE --

3 THE COURT: I'M SORRY, I DIDN'T ASK MY
4 QUESTION VERY WELL.

5 THERE'S SUBSECTION II AND SUBSECTION III.
6 AND AS I UNDERSTAND YOUR STATUTORY CONSTRUCTION
7 ARGUMENT, YOU ARE SAYING THAT III IS A REFINEMENT
8 OF II.

9 IN OTHER WORDS, IT'S NOT ENOUGH THAT
10 THERE BE TWO CLASSES OF STOCK OR SECURITY, THERE
11 ALSO HAS TO BE A PARTICULAR CHARACTERISTIC OF THE
12 WARRANT IN THIS CASE.

13 MR. TOSCHER: YOUR HONOR, THAT'S CORRECT.

14 IN TALKING ABOUT (II) WHICH IS A
15 THRESHOLD ISSUE, WHETHER IT EVEN APPLIES TO
16 WARRANTS.

17 WE DON'T THINK IT DOES, (II) BY
18 CONSTRUCTION OF THE REGULATION, I COULD POINT OUT
19 NUMEROUS EXAMPLES POINTED TO DEBT, EQUITY TYPE
20 ISSUES, NOT TO WHETHER A WARRANT IS A SECOND CLASS
21 OF STOCK. THAT HAS ITS OWN REGULATION, AND THAT'S
22 (III).

23 THE COURT: SO (II) YOUR VIEW IS THE
24 GOVERNMENT CANNOT RELY UPON THAT FOR ANYTHING, THAT
25 SINCE WE ARE TALKING ABOUT WARRANTS, THEY COULD

1 ONLY RELY ON (III). (III), IS THE EXCLUSIVE
2 TREATMENT OF WARRANTS IN THIS PARTICULAR STATUTE
3 AND THAT THE WARRANTS HAVE TO BE SUBSTANTIALLY
4 CERTAIN TO BE EXERCISED, CORRECT?

5 MR. TOSCHER: THAT'S CORRECT, YOUR HONOR.

6 THE COURT: AND THE POSITION BEING TAKEN
7 BY THE GOVERNMENT IS THESE PROVISIONS ARE SEPARATE
8 THINGS, IT'S SOMETHING TO QUALIFY A WARRANT AND
9 QUALIFY UNDER (II) WITHOUT QUALIFYING UNDER (III).

10 MR. TOSCHER: THAT'S THE POSITION,
11 YOUR HONOR.

12 THE COURT: ALL RIGHT.

13 ANYTHING ON THAT? I JUST WANTED TO
14 DEFINE THE ISSUE.

15 MR. DARMSTADTER, III: YES, YOUR HONOR.

16 I THINK THAT PRETTY MUCH DOES DEFINE THE
17 ISSUE.

18 WE FEEL VERY STRONGLY THAT (II) DOES
19 APPLY TO THE INSTRUMENTS THAT WERE ISSUED IN THIS
20 CASE. THERE WAS NO OTHER PURPOSE FOR THESE
21 INSTRUMENTS OTHER THAN TO SEPARATE THE EQUITY FROM
22 THE --

23 THE COURT: RIGHT. BUT WE ARE TALKING
24 ABOUT STATUTORY CONSTRUCTION, BECAUSE THE ONLY
25 REFERENCE TO WARRANTS IS IN (III), CORRECT?

1 MR. DARMSTADTER, III: WELL, THE ONLY --
2 THE COURT: THE WORD "WARRANTS" IS ONLY
3 USED THERE.

4 MR. DARMSTADTER, III: IT'S ONLY USED
5 THERE, BUT WE BELIEVE THAT THESE WERE WARRANTS
6 REALLY ONLY IN FORM AND NOT IN SUBSTANCE.

7 THE COURT: RIGHT. NO, I UNDERSTAND YOUR
8 ARGUMENT.

9 YOU ARE SAYING THE COURT SHOULDN'T GET
10 TOO BOTHERED BY THAT, THAT WHAT THE COURT SHOULD
11 LOOK AT IS THE REALITY OF THE INTEREST THAT WAS
12 CREATED AND DECIDE WHICH OF THESE SECTION IT FALLS
13 UNDER.

14 MR. DARMSTADTER, III: AND (II) IS ABOUT
15 AS BROAD AS IT COULD BE IN TERMS OF TRYING COVER
16 ANY INSTRUMENT. IT'S KIND OF A REGULATOR'S CRY TO,
17 HEY, THIS IS WHAT WE WANT TO PREVENT. AND WE THINK
18 THE UNDISPUTED FACTS SHOW THAT THAT'S EXACTLY WHAT
19 KPMG DID IN DESIGNING THESE WARRANTS SO THEY WOULD
20 PAY THE TAX SHELL GAME.

21 THE COURT: WELL, I HAVE QUESTIONS FOR
22 BOTH OF YOU AND YOU CAN BOTH BE SEATED IF YOU LIKE.

23 I HAVE SPECIFIC QUESTIONS THAT GO TO THIS
24 STATUTORY CONSTRUCTION ISSUE.

25 AND THE QUESTION I HAVE FOR THE

1 GOVERNMENT IS, IT SEEMS TO ME WHAT THE FAMILY WAS
2 LOOKING FOR HERE IS A SITUATION WHERE THEY WOULDN'T
3 HAVE TO EXERCISE THE WARRANTS.

4 IN OTHER WORDS, THE WARRANTS WERE THEIR
5 SECURITY IN THE EVENT THAT SOMETHING WENT AWRY WITH
6 THE MANAGEMENT OF THE COMPANY.

7 NOT ONLY IS THERE NO CERTAINTY OR
8 SUBSTANTIAL CERTAINTY THAT THE WARRANTS WOULD BE
9 EXERCISED, BUT THE WHOLE IDEA IS THEY WOULD NEVER
10 BE EXERCISED.

11 IS THERE SOMETHING WRONG WITH THE VIEW?
12 BECAUSE IT SEEMS TO ME THAT'S WHAT THE FACTS ARE.

13 MR. DARMSTADTER, III: YOUR HONOR, THAT
14 APPLIES TO (III), THE SUBSTANTIAL CERTAINTY.

15 AND I HOPE WE WERE ABLE TO EFFECTIVELY
16 DEMONSTRATE JUST HOW IN THE MONEY, TO USE A TERM OF
17 ART, THESE WARRANTS ARE.

18 IN OTHER WORDS, HOW MUCH FREE MONEY
19 ESSENTIALLY THE EXERCISER OF WARRANTS WOULD GET
20 UPON THEIR EXERCISE.

21 WE BELIEVE THAT KPMG SPECIFICALLY GAINED
22 THE SUBSTANTIAL CERTAINTY PART OF THE REGULATION,
23 THE TEST REQUIRES THAT YOU CONSIDER ALL THE FACTS
24 AND CIRCUMSTANCES, AND ONE IS HOW DEEPLY THEY ARE
25 IN THE MONEY.

1 IT'S LIKE LEAVING, YOU KNOW, A \$50 BILL
2 ON THE GROUND, ULTIMATELY SOMEBODY IS GOING TO PICK
3 IT UP. AND THERE'S AN ECONOMIC COMPULSION, WE
4 BELIEVE, FROM THE OBJECTIVE STANDARD THAT IF YOU
5 CAN INSTANTLY GET MONEY THROUGH EXERCISE OF THE
6 WARRANTS, THAT YOU WOULD GO AHEAD AND DO IT.

7 THE COURT: WELL, LET ME SEE IF I'M
8 HEARING YOU CORRECTLY BECAUSE THIS IS PRETTY
9 TECHNICAL.

10 THE WHOLE DESIGN WAS THAT THEY WOULDN'T
11 EVER HAVE TO ACTUALLY EXERCISE THE WARRANTS BECAUSE
12 THE WARRANTS WOULD BE SO VALUABLE THAT THEY WOULD
13 GET THEIR INTEREST BACK WHETHER OR NOT THE WARRANTS
14 WERE EXERCISED. THERE WOULD BE NO REASON FOR THE
15 VOTING SHARES NOT TO REINSTATE THE MONEY INVESTED.
16 BECAUSE THE EFFECT OF NOT DOING SO WOULD BE
17 UNTENABLE.

18 SO THEREFORE, JUST THE MERE THREAT THAT
19 THE WARRANTS COULD BE EXERCISED WAS ENOUGH.

20 IS THAT YOUR THEORY?

21 MR. DARMSTADTER, III: AS PART OF THE S,
22 C SQUARED ARRANGEMENT THERE WAS AN UNDERSTANDING
23 THAT THE WARRANTS WOULD BE TAKEN INTO ACCOUNT IN
24 TERMS OF THE VALUATION OF WHAT WAS TRANSFERRED TO
25 THE PENSION PLAN.

1 AND WHEN THEY WENT TO APPRAISE THE VALUE
2 OF THE STOCK THAT WAS TRANSFERRED TO THE PENSION
3 PLAN, BOTH AT THE TIME OF DONATION, AT THE TIME OF
4 REDEMPTION, THEY TOOK INTO ACCOUNT AS IF THE
5 WARRANTS WERE EXERCISED --

6 THE COURT: RIGHT.

7 SARAH FRAZER, I MEAN, SHE WAS VERY CLEAR
8 ABOUT IT, SHE WAS A HUNDRED PERCENT CERTAIN THESE
9 WARRANTS WOULD BE EXERCISED BECAUSE TO DO SO WOULD
10 BE TO BASICALLY THROW AWAY MONEY.

11 SO WE THINK THAT THE PROPER WAY TO VIEW
12 THAT IS AS A LEGAL IMPEDIMENT. IN OTHER WORDS, ARE
13 THE WARRANTS DEEP IN THE MONEY, AND IS THERE SOME
14 STRONGER REASON AS TO WHY SOMEBODY WOULDN'T
15 EXERCISE THESE WARRANTS?

16 AND IF THEY ARE GOING TO TAKE INTO
17 ACCOUNT FOR PURPOSES OF VALUATION, THE WARRANTS, IN
18 THEIR PURE DILUTED EFFECT WHICH BASICALLY DESTROYS
19 THE VALUE OF THE SHARES HELD BY THE PENSION PLAN,
20 THEN WE THINK THAT PART OF THE REQUIREMENT IS
21 SATISFIED.

22 IN OTHER WORDS, THEY'VE TRIED TO
23 CIRCUMVENT THE REGULATION BY SAYING, WELL, IF WE
24 ALL PRETEND THAT THE WARRANTS ARE GOING TO BE
25 EXERCISED THEN WE REALLY DON'T HAVE TO EXERCISE.

1 THE COURT: GOT YOU.

2 IN OTHER WORDS, I DON'T HAVE TO SHOOT THE
3 GUN IN ORDER TO PUT THE FEAR OF DEATH IN YOU. AS
4 LONG AS I POINT THE GUN AT YOUR HEAD.

5 IT'S A CRUDE EXAMPLE, BUT THAT'S HOW YOU
6 ARE CHARACTERIZING THESE WARRANTS, CORRECT?

7 MR. DARMSTADTER, III: THAT'S HOW WE ARE
8 CHARACTERIZING THE WARRANTS.

9 THEY HAD TO BE TAKEN INTO ACCOUNT FOR
10 PURPOSES OF DILUTION.

11 AND YOUR HONOR, THE PURPOSE OF THESE
12 WARRANTS IS -- WAS CLEAR. IT WAS SIMPLY TO
13 MISALLOCATE INCOME FROM, IN ORDER TO --

14 THE COURT: I UNDERSTAND YOUR THEORY.

15 YOU ARE SAYING THAT THE QUESTION OF
16 WHETHER THE WARRANTS ACTUALLY WOULD BE PHYSICALLY
17 EXERCISED, WHETHER THE FAMILY MEMBERS WOULD SAY
18 HERE WE ARE EXERCISING THE WARRANTS, BECAUSE OF THE
19 WAY THAT THE DEAL WAS CONSTRUCTED, THEY DIDN'T NEED
20 TO DO THAT.

21 MR. DARMSTADTER, III: THEY WERE
22 EFFECTIVELY EXERCISED.

23 THE COURT: RIGHT. THE FACT THAT THE
24 WARRANTS EXISTED WAS ENOUGH.

25 AND THAT IS YOUR THEORY UNDER (III). AND

1 YOUR THEORY UNDER (II) IS THAT EVEN IF YOU DON'T
2 CONSTRUE IT THAT WAY, THIS CLEARLY WAS AN EQUITY
3 INTEREST AND IT WAS COVERED BY (II).

4 MR. DARMSTADTER, III: CORRECT,
5 YOUR HONOR.

6 THE COURT: ALL RIGHT.

7 LET ME GET THE RESPONSE FROM SANTA CLARA
8 ON THAT. BECAUSE IT SEEMS TO ME THE GOVERNMENT'S
9 GOT SOME FACTS TO SUPPORT WHAT COUNSEL JUST SAID,
10 SO HOW DO YOU DEAL WITH THAT.

11 MR. TOSCHER: YES, YOUR HONOR.

12 ON (III), I THINK THE PRESENCE OF THE
13 WARRANT NEEDS TO BE TAKEN INTO ACCOUNT FOR
14 VALUATION PURPOSES. BUT THE REGULATION CLEARLY
15 TALKS ABOUT AN EXERCISE OF THE WARRANT NOT THE
16 EXISTENCE OF THE WARRANT.

17 AND VALUATION OR CONSIDERING IT FOR
18 VALUATION IS SOMETHING ENTIRELY DIFFERENT. IF YOU
19 LOOK AT THE LANGUAGE OF THE REGULATION, IT SAYS IT
20 WOULD BE EXERCISED, SUBSTANTIALLY CERTAIN TO BE
21 EXERCISED, NOT THE EXISTENCE OF THE WARRANT.

22 SO WHILE I THINK THE GOVERNMENT'S
23 ARGUMENT REALLY HAS NO SUPPORT IN THE CONTEXT OF
24 THE REGULATION, IT JUST SIMPLY DOESN'T.

25 THE COURT: SO YOU READ THE REGULATION

1 LITERALLY, THAT MEANS YOU WIN ON THREE, BUT THEN
2 WHY WOULDN'T TWO BE SUFFICIENT TO BE A CATCH ALL?

3 BECAUSE CLEARLY THESE WARRANTS HAVE
4 VALUE, THEY AREN'T JUST SOMETHING THAT IS FLOATING
5 OUT THERE. THE REASON THAT THEY EXIST, IT SEEMS TO
6 ME FROM THE UNDISPUTED FACTS, IS TO GIVE YOUR
7 CLIENTS A MEANS FOR RE COOPING THEIR INVESTMENT.

8 MR. TOSCHER: THEY ARE PROPHYLACTIC
9 MEASURES YOUR HONOR, THAT'S CORRECT.

10 I GUESS IF ONE READS THE REGULATION, ONE
11 WOULD HAVE TO REALLY CONTORT OR STRETCH (II) TO
12 COME TO ITS APPLICATION. JUST BITE INSTRUCT I, THE
13 REGULATION ITSELF, IT APPLIES TO DEBT LIKE
14 INSTRUMENTS.

15 THERE ARE TWO REFERENCES IN THE
16 REGULATION ITSELF BOTH UNDER, I THINK, (I) AND
17 LITTLE FOUR, ROMAN NUMERAL, WHICH BY ITS STRUCTURE
18 MAKE CLEAR THAT IT DOESN'T APPLY TO WARRANTS.

19 LITTLE (I) SAYS, "UNDER NO CIRCUMSTANCES
20 WILL (II) APPLY IF THE SAFE HARBOR IS MET." HOW
21 COULD THERE BE A SAFE HARBOR FOR WARRANTS
22 STRUCTURED IF (II) COULD OVERRULE THAT?

23 THE COURT: WHAT COUNSEL IS SAYING IS
24 THESE ARE WARRANTS IN NAME ONLY. HE'S SAYING YOU
25 HAVE TO LOOK THROUGH THE FORM AND LOOK THROUGH THE

1 SUBSTANCE OF WHAT'S BEING DONE.

2 AND THE GOVERNMENT IS SAYING THESE
3 CLEARLY ARE, THEY AREN'T JUST PROPHYLACTIC, THEY
4 ARE EQUITY INTERESTS THAT DON'T HAVE TO BE ASSERTED
5 BECAUSE OF THE UNDERSTANDING THAT EXISTED AT THE
6 TIME THEY WERE CREATED BUT THEY CERTAINLY COULD BE
7 ASSERTED AND THEY WOULD GET BACK ALL THE MONEY THEY
8 PUT IN.

9 MR. TOSCHER: AND I THINK THAT'S THE
10 FUNDAMENTAL FLAW IN THE GOVERNMENT'S POSITION,
11 YOUR HONOR, IS ALL WARRANTS HAVING EQUITY
12 COMPONENT.

13 IT'S AN OPTION TO BUY ON THE UP SIDE.
14 THEY CLEARLY HAVE AN EQUITY COMPONENT. BUT THE TAX
15 LAW FOR MANY YEARS HAS DISTINGUISHED BETWEEN A
16 WARRANT WHICH DOES HAVE AN EQUITY COMPONENT AND
17 STOCK OWNERSHIP. THOSE ARE TWO SEPARATE ISSUES.

18 THAT ISSUE WAS JOINED WHEN THEY FIRST
19 PROMULGATED THIS REGULATION. AND THEY FINALLY CAME
20 OUT WITH THE COMPROMISE OR DEVELOPMENT OF THIS
21 REGULATION WHICH SAID WE WOULD ALLOW WARRANTS FOR S
22 CORPORATIONS EVEN THOUGH WE COULD STORE EQUITY
23 VALUE, PROVIDED YOU MEET THESE TWO REQUIREMENTS OR
24 DON'T -- THAT DON'T FALL AFOUL OF THESE TWO OR YOU
25 CAN COMPLY WITH THE SAFE HARBOR PROVISION.

1 THE COURT: OKAY. ALL RIGHT.

2 SO TELL ME WHY UNDER THE FACTS THAT ARE
3 PRESENTED HERE IN THE ARGUMENT WE'VE JUST BEEN
4 ENGAGING IN, THAT YOUR CLIENT IS ENTITLED TO
5 SUMMARY JUDGEMENT THAT THIS WAS ALL ABOVE BOARD AND
6 FINE AND THERE'S NO ISSUE OF FACT AS TO WHETHER
7 THIS WAS AN ABUSIVE PRACTICE.

8 MR. TOSCHER: OKAY.

9 LET ME START WITH THE SECOND CLASS OF
10 STOCK ISSUE, YOUR HONOR, WHY WE ARE ENTITLED.

11 I THINK BASED UPON ALL THE FACTS, THE
12 UNDISPUTED FACTS, IT WAS NOT SUBSTANTIALLY CERTAIN
13 THAT THESE WARRANTS WOULD BE EXERCISED.

14 AND IF THE COURT COULD FIND THERE'S NO
15 FACTUAL DISPUTE ON THAT, WE ARE ENTITLED TO
16 JUDGMENT UNDER WHAT WE BELIEVE IS THE CORRECT
17 INTERPRETATION.

18 THE COURT: ON THIS C CORP VERSUS S CORP?

19 MR. TOSCHER: YOUR HONOR, I WANT TO PUT
20 THAT ASIDE AND NOW I'M HAPPY TO ADDRESS THE ISSUE.

21 PLAINTIFF BOWES, IN RESPONDING TO, WELL
22 THE GOVERNMENT HAS ASSERTED IF IT IS AN S
23 CORPORATION THAT THE ALLOCATION OF INCOME SHOULD
24 NOT BE ALLOCATED 90 10.

25 WE START FROM THE PREMISE, AND THIS IS A

1 VERY CAREFULLY DEVELOPED TAX STRUCTURE, THAT INCOME
2 IN AN S CORPORATION IS ALLOCATED BASED UPON SHARE
3 OWNERSHIP. ABSOLUTELY CLEAR. YOU CAN'T CONSIDER
4 DIFFERENT VALUATIONS OF INTERESTS. IT'S ATTEMPTED
5 TO BE STRAIGHTFORWARD BASED UPON SHARE OWNERSHIP.

6 WE COULD STOP RIGHT THERE. BUT THE
7 GOVERNMENT SAYS, NO, THEY DON'T REALLY, THEY CAN'T
8 DISPUTE THAT BECAUSE THE STATUTE IS CLEAR, THE
9 SUPREME COURT SAID YOU READ THE STATUTE IN GITLITZ.

10 BUT THE ARGUMENT IS WELL, THE L.A. PLAN
11 WAS REALLY NOT THE OWNER FOR TAX PURPOSES.

12 THE COURT: IT WAS A PARKING PLACE.

13 MR. TOSCHER: A PARKING PLACE.

14 AND THAT GETS THE QUESTION OF WHETHER,
15 ONE, AND I THINK THERE'S REALLY TWO THEORIES.
16 UNDER, WERE THEY THE BENEFICIAL OWNER, WE DON'T
17 DISAGREE WITH THE GOVERNMENT UNDER THE BENEFITS AND
18 BURDEN TEST.

19 OR TWO, I GUESS THE COURT COULD APPLY THE
20 SHAM THEORY, WE DON'T THINK IT APPLIES AND THAT'S
21 WHY WE MOVE FOR SUMMARY JUDGEMENT ON THE ISSUE
22 BASED UPON THE FACTS.

23 LET ME JUST ADDRESS ONE THING,
24 YOUR HONOR.

25 THE GOVERNMENT POINTS TO THIS PARKING LOT

1 COMMENT. IF ONE READS THE ENTIRE TRANSCRIPT,
2 WHICH, OF THOSE MINUTES OF THE L.A. PENSION PLAN,
3 IT IS ABSOLUTELY CLEAR THEY VIEW THEMSELVES AS AN
4 OWNER OF THE STOCK.

5 IT WAS A FLIPPANT REMARK IN THE SAME
6 MEETING THE COMMISSIONER WHO SAID IT TALKED ABOUT
7 WHETHER THE PROFITS THAT THEY WOULD MAKE ON SANTA
8 CLARA MIGHT GET SKIMMED OFF BY THE CITY OF L.A.
9 BECAUSE IT WOULD INTERFERE WITH THEIR PENSION
10 CONTRIBUTION.

11 SO JUST LIKE THERE WAS NO SKIMMING, I
12 THINK THAT'S ONE WORD TAKEN OUT OF CONTEXT AND I
13 THINK ONE HAS TO EVALUATE, WHAT DID THEY HAVE?

14 THE COURT: ALL RIGHT.

15 SO WHEN THE SHARES WERE WITH THE PENSION
16 PLAN, DID THOSE SHARES PRODUCE INCOME? WAS THAT
17 MONEY PRODUCTIVE?

18 MR. TOSCHER: YOUR HONOR, DURING THE
19 THREE AND A HALF YEARS SANTA CLARA WAS EARNING
20 INCOME, WHEN THE MARKET TOOK OFF RIGHT AFTER THE
21 DOT COM BUST.

22 THE COURT: RIGHT.

23 MR. TOSCHER: AND EARNING A LOT OF
24 INCOME, BUT THAT INCOME WAS NOT DISTRIBUTED TO
25 THEM. BUT THE INCOME IN AN S CORPORATION IS

1 ALLOCATED BASED UPON SHARE OWNERSHIP.

2 THE COURT: SO -- BUT WHAT I GUESS WHAT
3 I'M GETTING AT -- SO DID THE PENSION PLAN ACTUALLY
4 GET INCOME FROM THE FACT THAT THEY HELD THOSE
5 SHARES?

6 MR. TOSCHER: WELL, THERE WERE
7 DISTRIBUTIONS, BUT COMPARED TO THE INCOME THEY WERE
8 SMALL DISTRIBUTIONS, BUT THEY DID GET SOME INCOME
9 AND THEY APPRECIATE IT. THEY PARTICIPATED IN THE
10 SUBSTANTIAL APPRECIATION OF THE STOCK FROM THE TIME
11 IT WAS CONTRIBUTED TO THAT, FROM THE TIME IT WAS
12 REDEEMED.

13 THE COURT: RIGHT. BUT THAT'S WHAT I'M
14 TRYING TO FIGURE OUT.

15 WHAT DID THE PENSION PLAN, AND I DON'T
16 MEAN TO BE FLIP HERE, BUT WHAT IS THE RENT THEY GOT
17 FROM THE PARKING PLACE? I MEAN IF YOU --

18 MR. TOSCHER: DO I HAVE TO ANSWER THAT?

19 NO, YOUR HONOR.

20 WHAT DID THE PENSION PLAN RECEIVE FROM
21 SANTA CLARA? I BELIEVE THERE WERE DIVIDEND
22 DISTRIBUTIONS OF A FEW HUNDRED THOUSAND, 2 TO
23 300,000, I MAY BE OFF THERE.

24 AND ULTIMATELY WHEN THEY TENDERED THE
25 STOCK FOR REDEMPTION THEY RECEIVED 1.4 OR 56

1 MILLION.

2 THE COURT: SO THEY DID RECEIVE VALUE.
3 IT WAS NOT A SHAM TRANSACTION IN THE SENSE THAT
4 THEY GOT NOTHING FOR IT.

5 MR. TOSCHER: THAT'S CORRECT, YOUR HONOR.

6 THE COURT: THANK YOU.

7 ANYTHING FURTHER YOU WANT TO SAY BEFORE I
8 GET A RESPONSE FROM THE GOVERNMENT?

9 ALL RIGHT. THANK YOU.

10 MR. DARMSTADTER, III: YOUR HONOR, IT WAS
11 \$200,000 THAT THE PENSION PLAN GOT IN TERMS OF
12 MONEY BEING DISTRIBUTED. AND THAT WAS ESSENTIALLY
13 PART OF THE REDEMPTION AGREEMENT WHEREBY IF THEY
14 AGREED TO HOLD ON TO THE STOCK FOR ANOTHER YEAR
15 THEY WOULD GET THAT AMOUNT OF THE PAYMENT.

16 IT HAD NO RELATIONSHIP WHATEVER TO WHAT
17 WAS GOING ON IN SANTA CLARA.

18 THE COURT: IS IT FAIR TO SAY THE WAY YOU
19 SEE THE CASE IS THAT SANTA CLARA NEEDED A PLACE TO
20 PUT THE SHARES SO THAT THEY WOULD NOT HAVE THEY
21 WOULDN'T BE TAXABLE AND THEY PAID A FEE TO THE
22 PENSION FUND WHICH WAS ON THE ORDER OF A COUPLE
23 HUNDRED THOUSAND DOLLARS.

24 IS THAT THE WAY YOU SEE WHAT ACTUALLY
25 HAPPENED?

1 MR. DARMSTADTER, III: THAT'S EXACTLY HOW
2 WE SEE WHAT HAPPENED. AND WE PROVIDED THE COURT
3 WITH A LOT OF, INCLUDING THE MINUTES WHICH ARE VERY
4 ILLUMINATING, THE MINUTES BETWEEN THE KPMG AND THE
5 COMMISSIONERS OF THE PENSION PLAN.

6 AND THE COURT SHOULD UNDERSTAND THAT THIS
7 IS A DEFINED BENEFIT PENSION PLAN, THEY ARE NOT
8 USED TO RECEIVING GIFTS.

9 SO THIS WAS SOMETHING VERY UNUSUAL TO
10 THEM, AND KPMG APPROACHED THEM AND BASICALLY
11 EXPLAINED THE TRANSACTION THAT YOU WILL ACCEPT THIS
12 STOCK FOR A PERIOD OF TIME, THAT WE WILL PAY YOU A
13 MINIMUM PAYMENT, GUARANTEED MINIMUM PAYMENT. AND
14 THEN AT THE END OF THE TIME PERIOD, WE WILL -- YOU
15 CAN REDEEM THE STOCK AND MAYBE YOU WILL GET
16 SOMETHING EXTRA. BUT IT WAS ALWAYS THE ORIGINAL
17 SHAREHOLDERS.

18 IF YOU LOOK AT THE REDEMPTION AGREEMENT,
19 THAT WOULD DECIDE WHAT THAT EXTRA AMOUNT WOULD BE.
20 AND THAT'S EXACTLY HOW THE L.A. PENSION PLAN
21 TREATED THESE STOCK CERTIFICATES. THEY DIDN'T
22 TREAT THEM AS THEY TREAT OTHER ASSETS.

23 AND HERE WE HAVE A STARK DIFFERENCE
24 BETWEEN A PENSION PLAN AND ITS OFFICERS WHO HAVE
25 FIDUCIARY DUTIES TO MANAGE ASSETS AND NEEDS.

1 THEY NEVER PAID ANY HEED TO THEM, THEY
2 NEVER ACTED LIKE AN EQUITY OWNER. THEY HELD THEM
3 FOR ZERO VALUATION. AND WHEN IT CAME TIME FOR
4 REDEMPTION, AT LEAST PRIOR TO THE SENATE CONTACTING
5 THE PENSION PLAN AND TELLING THEM, YOU KNOW --

6 THE COURT: THIS IS NOT OKAY.

7 MR. DARMSTADTER, III: THIS IS NOT OKAY.

8 THEY BASICALLY -- KPMG WOULD NOTIFY THEM
9 ITS REDEMPTION TIME AND THEY RETRIEVED THE STOCK
10 THEN THEY WOULD GET THEIR PAYMENT.

11 IT WAS NOT IN ANY WAY APPROACHING AN
12 EQUITY OWNERSHIP INTEREST OR A 90 PERCENT EQUITY
13 OWNERSHIP.

14 THE COURT: THEY NEVER ACTED AS REAL
15 OWNERS, IS YOUR VIEW.

16 MR. DARMSTADTER, III: NO, THEY DIDN'T.

17 AND, YOU KNOW, WE ARE NOT JUST SAYING
18 THAT, YOU KNOW, THEY DIDN'T -- THEY DIDN'T, YOU
19 KNOW, GO TO SHAREHOLDER MEETINGS AND ALL OF THAT.

20 THEY DIDN'T ACT IN ANY WAY, SHAPE OR FORM
21 AS AN OWNER AS OPPOSED TO THEIR OTHER ASSETS WHICH
22 THEY CAREFULLY MANAGE AND HAD FIDUCIARY
23 RESPONSIBILITIES OVER.

24 THE COURT: SO THE PENSION FUND HAD
25 PEOPLE WHO MANAGE THEIR INVESTMENTS AND WHO DID SO

1 IN AN ACTIVE, HANDS-ON WAY BUT NOT WITH RESPECT TO
2 THESE SHARES.

3 MR. DARMSTADTER, III: THIS PENSION PLAN
4 HAD MILLIONS OF DOLLARS UNDER MANAGEMENT AND THEY
5 TREATED THOSE ASSETS COMPLETELY DIFFERENTLY THAN
6 THEY TREATED THIS -- IT WAS TREATED AS A PROGRAM,
7 WHERE ESSENTIALLY THEY WOULD CALENDAR THE DATE OF
8 REDEMPTION, AND KPMG WOULD CALL, THEM UP SOMETIMES
9 THEY WOULD GET THE DIVIDENDS TO EXTEND THE PERIOD
10 OF TIME.

11 THE COURT: SO THIS WAS SORT OF A LOW
12 IMPACT WAY OF GETTING SOME ADDITIONAL FEES.

13 MR. DARMSTADTER, III: THAT'S RIGHT.

14 I MEAN, IN FACT THE SCHOTT ORGANIZATION,
15 MR. SCHOTT EVEN CHARACTERIZED THE PAYMENTS OF THE
16 PENSION PLAN AS A FEE.

17 THE COURT: ALL RIGHT. OKAY.

18 MR. DARMSTADTER, III: NOW WITH RESPECT
19 TO THE WARRANTS, YOUR HONOR, I THOUGHT AT LEAST ONE
20 OF THE MOST USEFUL THINGS TO KIND OF GO OVER THE
21 DAMAGE THAT WAS DONE TO THE OUTSTANDING SHARES BY
22 REASON OF THE CREATION OR THE ISSUANCE OF THESE
23 WARRANTS JUST TO KIND OF MAKE SURE THAT THAT REALLY
24 IS CLEAR, AND WE ARE USING PLAINTIFF'S OWN
25 APPRAISAL OF THAT WHICH IS \$1.7 MILLION. THAT WAS

1 WHAT MESIROW OR WENDY SHARON WHEN SHE APPRAISED
2 SANTA CLARA AT THE TIME OF DONATION.

3 AND AT THAT POINT IN TIME THERE WERE A
4 THOUSAND SHARES OF STOCK OUTSTANDING OF WHICH THEY
5 WERE GOING GIVE 90 OR 900 TO THE PENSION PLAN. AND
6 EACH SHARE OF STOCK WOULD HAVE BEEN WORTH OVER
7 \$1,700.

8 HOWEVER, AFTER THE WARRANTS WERE ISSUED,
9 THE VALUE OF THOSE OUTSTANDING SHARES WENT FROM
10 \$1,700 DOWN TO HUNDRED 81 DOLLARS. AND THE ONLY
11 REASON FOR THAT WAS THE ISSUANCE OF THESE WARRANTS.

12 THAT I THINK IS A DEMONSTRATIVE WAY TO
13 ESTABLISH HOW MUCH EQUITY WAS LITERALLY TRANSFERRED
14 FROM THE OUTSTANDING STOCK TO THE WARRANTS.

15 THE COURT: JUST, CAN YOU WALK ME THROUGH
16 THE ARITHMETIC AGAIN.

17 MR. DARMSTADTER, III: SURE.

18 THE COURT: BEFORE THE WARRANTS WERE
19 ISSUED SANTA CLARA WAS WORTH 1.7 MILLION.

20 MR. DARMSTADTER, III: AND I SHOULD SAY,
21 YOUR HONOR, THE GOVERNMENT HAS RETAINED EXPERTS AND
22 WE BELIEVE THAT SANTA CLARA WAS WORTH \$40 MILLION
23 OR THERE ABOUT. SO THERE'S A HUGE DISCREPANCY.

24 THE COURT: BUT WE ARE JUST TALKING ABOUT
25 BOOK VALUE OF --

1 MR. DARMSTADTER, III: RIGHT.

2 THE COURT: SO AT THAT POINT IT'S WORTH
3 1.7 MILLION, AND THERE'S HOW MANY SHARES OF STOCK?

4 MR. DARMSTADTER, III: A THOUSAND SHARES
5 OF STOCK OUTSTANDING.

6 THE COURT: ALL RIGHT.

7 SO THE WARRANTS DILUTE -- YOUR THEORY IS
8 THE WARRANTS DILUTE THE POOL OF EQUITY OWNERSHIP BY
9 ADDING, I FORGET -- I MEAN, I CAN'T IMMEDIATELY DO
10 THE MATH BUT IT'S LIKE A 90 PERCENT, FACTOR OF
11 NINE.

12 MR. DARMSTADTER, III: RIGHT. FACTOR OF
13 NINE.

14 THEY COMPLETELY -- AND THERE HAS BEEN NO
15 REAL EXPLANATION, NO BUSINESS PURPOSES TO WHY SANTA
16 CLARA ISSUED WARRANTS. CERTAINLY NO ONE WITHIN
17 SCHOTT ORGANIZATION HAS ANY EXPLANATION OF THE
18 ISSUANCE OF THE WARRANTS. IT WAS ALL DONE BY KPMG
19 AS PART OF THE STRATEGY. THERE WAS NO LEGITIMATE
20 BUSINESS PURPOSE. AND OF COURSE CORPORATIONS CAN
21 ISSUE WARRANTS, THEY DO TO INCENTIVIZE EMPLOYEES --

22 THE COURT: OR EVEN LEGAL TAX SHELTERS,
23 RIGHT?

24 MR. DARMSTADTER, III: THAT'S TRUE,
25 YOUR HONOR.

1 THERE MAY BE MANY LEGITIMATE REASONS TO
2 ISSUE WARRANTS BUT IN THIS CASE THERE WERE NONE
3 OTHER THAN TO TRANSFER THE EQUITY AND KEEP THAT
4 WITH THE ORIGINAL SHAREHOLDERS WHILE THEY COULD DO
5 THIS BAIT AND SWITCH GAME TO AVOID PAYING ON THE
6 TAXES.

7 THAT'S WHY WE FEEL SO STRONGLY THAT (II)
8 APPLIES. IT'S AN ANTI ABUSE PROVISION THAT
9 SPECIFICALLY SHOULD APPLY WHEN A CORPORATION GOES
10 OUT OF ITS WAY TO CREATE THESE EQUITY-LIKE
11 INSTRUMENTS.

12 THE COURT: RIGHT. NO, I UNDERSTAND THE
13 ARGUMENT ABOUT HOW TO INTERPRET THE STATUTE AND I'M
14 JUST GOING TO HAVE TO MAKE A CALL ON IT.

15 SO I THINK I'VE GOT THE GOVERNMENT'S
16 VIEW. ANYTHING FURTHER THAT --

17 MR. TOSCHER: YOUR HONOR, JUST BRIEFLY ON
18 THE -- WHETHER THE PLAN WAS AN OWNER, ACTED LIKE AN
19 OWNER AND WHETHER SANTA CLARA TREATED THEM AS
20 OWNERS.

21 THE GOVERNMENT DISPUTES THAT, BUT I THINK
22 WHEN ONE BOILS DOWN TO THE FACTS OF WHAT HAPPENED
23 HERE, THEY WERE TREATED AS OWNERS.

24 WHAT THE GOVERNMENT IS TAKING ADVANTAGE
25 OF IN THE RHETORIC, IF YOU WILL, IS THE FACT THAT

1 THEY ARE NONVOTING SHAREHOLDERS. NONVOTING
2 SHAREHOLDERS DON'T VOTE ON THINGS, THEY DON'T GET
3 ACTIVELY INVOLVED IN MANAGEMENT, THEY NEVER
4 INTENDED TO GET ACTIVELY INVOLVED IN MANAGEMENT.

5 THE INVESTMENT OFFICER OF THE L.A.
6 PENSION PLAN, THESE WERE SMALL INVESTMENTS OR SMALL
7 ASSETS OF THE MULTI BILLION DOLLAR PLAN THAT THEY
8 HAD.

9 AND THE GOVERNMENT'S ARGUING WELL,
10 BECAUSE THEY DIDN'T BOOK A VALUE, THAT 162,000 THAT
11 WAS CONTRIBUTED, THEN THEY WEREN'T TREATED AS
12 OWNERS.

13 BUT IF ONE READS THE TRANSCRIPTS BECAUSE
14 THEY DON'T BOOK IT THAT WAY BECAUSE IT'S A GIFT AND
15 THEY ARE NOT SURE WHAT'S GOING TO GET REALIZED AT
16 THE END.

17 THE COURT: THEY DIDN'T BUY IT.

18 MR. TOSCHER: THEY DIDN'T BUY IT.

19 IN FACT, ONE READS MR. LOPEZ'S TESTIMONY
20 THAT'S PROBABLY THE DIFFERENCE. THEY DIDN'T BUY IT
21 AS A GIFT, THAT'S THE WAY THEY TREAT.

22 AND ADMITTEDLY, I THINK THE GOVERNMENT
23 DOES A REASONABLE EFFORT OF CLOUDING THE ISSUE.
24 BUT IF ONE LOOKS AT THE PURE FACTS OF A NONVOTING
25 SHAREHOLDER, WE SEEM TO HIT ALL THE BELLS AND

1 WHISTLES.

2 AND THE CASES RELIED UPON BY THE
3 GOVERNMENT ARE TOTALLY DIFFERENT AND OPPOSITE.
4 FAMILY SITUATIONS WHERE MOM AND DAD ARE BORROWING
5 OUT THE MONEY AND NEVER PAYING IT BACK.

6 SO I THINK THEY ARE THE OWNERS FOR TAX
7 PURPOSES.

8 ON THE WARRANTS, I UNDERSTAND THE
9 GOVERNMENT'S CONCERN WITH THE WARRANTS, BUT THIS
10 TRANSACTION WOULD HAVE NEVER BEEN STRUCTURED IF ONE
11 THOUGHT THE WARRANTS ATTEMPTED TO COMPLY.

12 THE COURT: IF THEY RELIED UPON THE
13 LANGUAGE OF THE REGULATION IN STRUCTURING IT.

14 MR. TOSCHER: THE SUPREME COURT RECENTLY
15 IN MAYO SAID WHEN THE IRS ISSUES A REGULATION, LIKE
16 CHEVRON IT'S EFFECTIVELY THE LAW.

17 THE COURT: INTERESTING YOU BRING CHEVRON
18 UP BECAUSE DOESN'T THE IRS'S CURRENT VIEW OF THIS
19 TYPE OF TRANSACTION TAKE THE POSITION THAT IT'S
20 IMPROPER?

21 MR. TOSCHER: OKAY. THAT'S A WONDERFUL
22 QUESTION. THERE'S A DIFFERENCE BETWEEN.

23 THE COURT: THEN AND NOW.

24 MR. TOSCHER: TREASURY REGULATION AND THE
25 IRS'S VIEW, THE IRS'S LITIGATION OF ITS FINE

1 LAWYERS TO THE DEPARTMENT OF JUSTICE.

2 I THINK WHAT THE SUPREME COURT WAS
3 GETTING AT IS IF YOU GO THROUGH THE REGULATORY
4 PROCEDURE, THE ADMINISTRATIVE PROCEDURE ACT IN
5 AREAS WHICH CONGRESS CAN'T MICRO MANAGE, YOU HAVE
6 TO GIVE DEFERENCE TO THE ADMINISTRATOR.

7 THAT DOESN'T GO DOWN TO BRIEFS IN COURT,
8 RULINGS OR NOTICES.

9 THE COURT: NO, OF COURSE NOT.

10 YOU ARE SAYING THERES ISN'T ANYTHING
11 THAT'S ENTITLED TO THE CHEVRON DEFERENCE WITH
12 REGARD TO THESE PARTICULAR DECLARATIONS

13 MR. TOSCHER: THE REGULATIONS ARE AND THE
14 REGULATIONS CLEARLY SUPPORT THE PLAINTIFF'S
15 POSITIONS IN THIS CASE.

16 THE COURT: THE WORDS OF THE REGULATIONS.

17 MR. TOSCHER: THAT'S CORRECT.

18 THE COURT: BUT THERE ISN'T ANY
19 INTERPRETATION OF THE REGULATIONS TO WHICH THIS
20 COURT NEEDS TO DEFER, OR THERE HASN'T BEEN ANOTHER
21 CASE LIKE THIS. THERE ISN'T A SITUATION WHERE
22 LOOKING AT THE WORLD AS IT EXISTED IN THE YEAR 2000
23 WE COULD GET ANY DIRECTION.

24 MR. TOSCHER: YOU ARE CORRECT,
25 YOUR HONOR. YOU ARE WRITING ON A CLEAN SLATE.

1 THE COURT: THANK YOU.

2 THE BRIEFS WERE GREAT. I THINK I'VE GOT
3 ENOUGH TO WORK WITH.

4 ANYTHING ELSE ANYONE WANTS TO SAY BEFORE
5 WE WRAP UP?

6 MR. DARMSTADTER, III: YOUR HONOR, JUST
7 ON THAT FINAL POINT, AND I'M SOMEWHAT SYMPATHETIC
8 TO MR. TOSCHER'S ARGUMENT THAT THE GOVERNMENT COMES
9 IN HERE AND SAYS, YOUR HONOR, INTERPRET THE
10 REGULATIONS --

11 THE COURT: YOU CAN'T BE THE REGULATOR
12 AND THE PROSECUTOR.

13 MR. DARMSTADTER, III: WE CAN'T.

14 AND WHAT I WOULD SAY TO THAT IS WE WOULD
15 ASK THE COURT TO INTERPRET THE REGULATION IN A WAY
16 THAT WOULD GIVE MEANING TO ITS PURPOSE IS TO
17 PREVENT A TRANSFER OF EQUITY, THESE IN THE MONEY
18 WARRANTS.

19 AND -- SO LET ME JUST FINISH OFF WITH
20 THAT THEN, YOUR HONOR.

21 THE COURT: I THINK IT'S VERY WELL JOINED
22 AND I WILL TAKE MY TIME.

23 IT WILL PROBABLY BE A MONTH OR SO BUT I
24 WILL GET A RULING TO YOU SOON.

25 MR. DARMSTADTER, III: AND WE APPRECIATE

1 THE COURT TAKING UP OUR TASK --

2 THE COURT: I WOULDN'T HAVE WANTED TO DO
3 THIS ON MY FRIDAY CALENDAR.

4 AND GENERALLY WHEN I SEE A TAX CASE
5 COMING I RUN THE OTHER WAY, BUT THIS ONE IS
6 ACTUALLY VERY INTERESTING.

7 MR. DARMSTADTER, III: THANK YOU,
8 YOUR HONOR.

9 MR. TOSCHER: THANK YOU VERY MUCH,
10 YOUR HONOR.

11 (WHEREUPON, THE PROCEEDINGS IN THIS
12 MATTER WERE CONCLUDED.)

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CERTIFICATE OF REPORTER

I, THE UNDERSIGNED OFFICIAL COURT
REPORTER OF THE UNITED STATES DISTRICT COURT FOR
THE NORTHERN DISTRICT OF CALIFORNIA, 280 SOUTH
FIRST STREET, SAN JOSE, CALIFORNIA, DO HEREBY
CERTIFY:

THAT THE FOREGOING TRANSCRIPT,
CERTIFICATE INCLUSIVE, CONSTITUTES A TRUE, FULL AND
CORRECT TRANSCRIPT OF MY SHORTHAND NOTES TAKEN AS
SUCH OFFICIAL COURT REPORTER OF THE PROCEEDINGS
HEREINBEFORE ENTITLED AND REDUCED BY COMPUTER-AIDED
TRANSCRIPTION TO THE BEST OF MY ABILITY.

SUMMER A. FISHER, CSR, CRR
CERTIFICATE NUMBER 13185